No. 21834

In the

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

v. 3450

WEYERHAEUSER COMPANY, *Appellant*

vs.

UNITED STATES OF AMERICA, *Appellee*

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF WASHINGTON

BRIEF FOR THE APPELLANT

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BRIEF FOR THE APPELLANT

OPINION BELOW

The District Court's Orders (R. 14, 17) are not officially reported, but are unofficially reported at 66-1 U.S. Tax Cas. ¶ 9417.

JURISDICTION

This appeal by Weyerhaeuser Company ("taxpayer"), involves federal income taxes for two calendar years, 1956 and 1957. Taxpayer timely claimed refunds for taxes and assessed interest paid for the years 1954-57 in the total amount of $641,289.38. (Pret. Ord., Para. 1(c), R. 4). The claims were disallowed. (Pret. Ord., Para. 1(d), R. 4). On June 3,

1965, within the time provided by Section 6532 of the Internal Revenue Code of 1954, taxpayer commenced an action in the District Court for recovery of the taxes and interest paid. (Pret. Ord., Para. 1(e), R. 4). Jurisdiction was conferred on the District Court by 28 U.S.C. § 1346 (1964).

The Trial Court's Pretrial Order identified two issues labeled therein "First Question Presented" and "Second Question Presented." (Pret. Ord., Paras. 2 and 4, R. 4-8). The two questions were unrelated factually or legally. Taxpayer's appeal to this Court involves only the Second Question Presented for the years 1956 and 1957. Jurisdiction is conferred on this Court by 28 U.S.C. § 1291 (1964).

QUESTION PRESENTED

Whether Section 631(a) of the Internal Revenue Code of 1954 applies to entitle taxpayer to capital gain treatment for gains realized by taxpayer on timber cut in the Seattle Watershed.

STATUTE INVOLVED

Sec. 631. GAIN OR LOSS IN THE CASE OF TIMBER OR COAL.

(a) ELECTION TO CONSIDER CUTTING AS SALE OR EXCHANGE.—If the taxpayer so elects on his return for a taxable year, the cutting of timber (for sale or for use in the taxpayer's trade or business) during such year by the taxpayer who owns, or has a contract right to cut, such timber (providing he has owned such timber or has held such contract right for a period of more than 6 months before the beginning of such

year) shall be considered as a sale or exchange of such timber cut during such year. If such election has been made, gain or loss to the taxpayer shall be recognized in an amount equal to the difference between the fair market value of such timber, and the adjusted basis for depletion of such timber in the hands of the taxpayer. Such fair market value shall be the fair market value as of the first day of the taxable year in which such timber is cut, and shall thereafter be considered as the cost of such cut timber to the taxpayer for all purposes for which such cost is a necessary factor. If a taxpayer makes an election under this subsection, such election shall apply with respect to all timber which is owned by the taxpayer or which the taxpayer has a contract right to cut and shall be binding on the taxpayer for the taxable year for which the election is made and for all subsequent years, unless the Secretary or his delegate, on showing of undue hardship, permits the taxpayer to revoke his election; such revocation, however, shall preclude any further elections under this subsection except with the consent of the Secretary or his delegate. For purposes of this subsection and subsection (b), the term "timber" includes evergreen trees which are more than 6 years old at the time severed from the roots and are sold for ornamental purposes. (Int. Rev. Code of 1954, § 631(a), 68A Stat. 213 [1954]).

STATEMENT

All facts deemed material by the parties were stipulated and set forth in the Pretrial Order and Supplement to Pretrial Order entered by the District Court. (R. 3-13).

History

Taxpayer's appeal involves gains realized by tax-

payer from the cutting of timber. The timber producing taxpayer's gains was located in the Watershed of the City of Seattle, Washington. (Pret. Ord., Para. 2, R. 5-8). Taxpayer has long been an owner of timber in the Seattle Watershed. Scott Paper Company has been another owner (as a successor in the Watershed to Soundview Pulp Company). (Pret. Ord., Para. 2(e), R. 5).

Anticipating logging in the Watershed by taxpayer and Scott, the City of Seattle became concerned for the preservation of its water supply. In 1945 and 1946, Seattle took two steps to preserve the purity of its water and to assure reforestation of its Watershed:

(i) First, it imposed a limit upon the annual cut of timber from private lands within the Watershed by means of an agreement of August 1, 1945, between Seattle, taxpayer, Scott, and other interested parties (admitted into evidence as Exhibit 1). (Pret. Ord., Paras. 2(f) and (g), R. 5-6).

(ii) As the second step in the preservation of its water supply, Seattle persuaded taxpayer and Scott to log jointly in a single logging operation. (Pret. Ord., Para. 2(f), R. 5). This second step ultimately led to this lawsuit.

Joint Logging by Taxpayer and Scott

To meet Seattle's requirement of joint logging in a single operation, taxpayer and Scott made two contracts. (Pret. Ord., Paras. 2(h) and (i), R. 6-7). Both were dated January 21, 1946.

One of the contracts was admitted into evidence as Exhibit 2. (R. 8-9). Taxpayer and Scott were the sole parties to Exhibit 2. As a result of Exhibit 2: (i) the previously separate timber of taxpayer and Scott was, for logging purposes, united; and (ii) taxpayer and Scott each thereafter had an undivided half share in the united taxpayer-Scott timber. For convenience, the united taxpayer-Scott timber will hereinafter be termed the "Watershed timber." Exhibit 2 thus paved the way for a single logging operation in the Watershed timber: (Para. I(a), at 2-3)

> "The parties hereto agree that within forty (40) years after August 1, 1945 all of the timber in their respective tracts of timber described in Exhibit A which shall be suitable for sawlogs and other forest products shall be logged and removed and that one-half thereof shall be delivered in the form of sawlogs and other forest products to each of the companies. Said timber shall be logged and delivered in a single operation in the manner provided in the logging contract. . . ."

The need for logging at two sites in the respective separate timber of the parties was thereby eliminated.

By uniting their separate timber and consenting to take *half* of the whole, taxpayer and Scott each ran an obvious risk. The risk was that their separate timber would not prove to be equal in value. In that event, one party would necessarily contribute more than half the value of the Watershed timber while receiving back (pursuant to Exhibit 2) only half.

Faced with the prospect of unequal contributions to the Watershed timber, taxpayer and Scott adopted

a simple remedy. They agreed that the party receiving (as its half share of the Watershed timber) more than it had contributed would pay for the excess: (Exh. 2, Para. II(b), at 4-5; see also Exh. 3, Para. IV(d), at 11-12)

> "The stumpage to be paid by one company to the other from time to time shall be determined as follows: Within ten (10) days after the close of each calendar year the following prices shall be applied to the quantities of logs, hemlock pulpwood, and forest products other than said logs and pulpwood, removed and delivered from the timber of each of the parties hereto during the preceding calendar year: (1) the zone stumpage prices for logs prescribed in Exhibit A hereto, (2) the price of fifty (50¢) cents per cord of 128 cubic feet for hemlock pulpwood, and (3) the agreed price or prices, under paragraph II(a) above, for forest products other than logs and hemlock pulpwood. The difference in total prices, as so determined, shall be computed and one-half thereof shall be forthwith paid by the company from whose timber the lesser total value was produced during said year to the company from whose timber the greater value was produced. . . ."

As is customary where timber is acquired in amounts which cannot be precisely known while the timber is standing, provision was made for the scaling (measuring) of the timber and payment at the time of cutting (see Exh. 3, Para. IV(c), at 10-11).

The fixed stumpage prices prescribed in Exhibit A to Exhibit 2 varied according to zone and species. They were fixed as follows:

EXHIBIT A

"W" Timber

Zone 1	Fir	$7.00 per M
	Other Species	$3.00 per M
Zone 2	Fir	$3.50 per M
	Other Species	$1.50 per M
Zone 3	Fir	$2.00 per M
	Other Species	$1.00 per M

"S" Timber

Zone 1	Fir	$7.00 per M
	Other Species	$3.00 per M
Zone 2	Fir	$3.50 per M
	Other Species	$1.50 per M
Zone 3	Fir	$2.00 per M
	Other Species	$1.00 per M

The second contract made by taxpayer and Scott on January 21, 1946, is entitled "Logging Contract" and was admitted into evidence as Exhibit 3 (R. 9). Exhibit 3 confirms the right of taxpayer and Scott each to receive delivery of a half share of the Watershed timber: (Exh. 3, Para. IV, at 11-12)

> "(d) As rapidly as rafts of logs are made up and scaled, the Timber Companies agree that the Operator shall, and it agrees that it will deliver (or cause Snohomish River Boom Company or its substitute agency, if any, to deliver) rafts of logs to the Timber Companies in such manner that each shall receive one-half of all logs of each species produced by the Operator throughout the life of this agreement from the timber of both Timber Companies and so that the total footage of logs of each species delivered to each of said Companies shall be kept as nearly equal as possible at all times. One-half of the other forest

> products produced by the Operator shall be delivered by it from time to time to each of the Timber Companies at such delivery point in or near Everett, Washington, as each shall specify for itself from time to time and in such manner as to keep the total cordage or footage delivered to each Company as nearly equal as possible at all times."

Exhibit 3 also implements the commitment to a single logging operation. It appoints Mountain Tree Farm Company, a corporation owned equally by taxpayer and Scott, as the single "Operator" to conduct the single logging operation in the Watershed timber: (Exh. 3, Para. I(a), at 2-3)

> " . . . The Timber Companies agree with each other and with the Operator that the Operator shall, and it hereby agrees to enter into the timber of both of the Timber Companies described on said Exhibit A and to cut, log and manufacture into sawlogs so much of said timber as shall be suitable for sawlogs and to cut and manufacture into pulp wood so much of the hemlock forest materials thereafter remaining in said timber as will make marketable pulp wood and, if Timber Companies hereafter jointly so direct, so much of the remaining forest materials of all other species as are marketable (all of which materials are hereinafter referred to as 'other forest products') and to deliver such logs and other forest products within the time and in the manner hereinafter provided."

Taxpayer and Scott were each obliged to pay half the costs of logging, including costs of roads and Mountain's compensation. (Exh. 2, Para. III, at 7-8; Exh. 3, Paras. II, at 5-6, and V, at 12-15).

At this point, on January 21, 1946, taxpayer and Scott had met Seattle's requirements:

(i) They had made ready for the single logging operation by uniting their separate timber and accepting undivided half shares in the whole pursuant to Exhibit 2.

(ii) They had implemented the single operation by appointing Mountain Tree Farm as the single operator pursuant to Exhibit 3.

As a result of meeting Seattle's requirements, taxpayer incurred a profound change in its economic position. Prior to signing Exhibits 2 and 3, taxpayer had an unqualified separate right to its former separate timber and no interest in Scott's timber. Afterward, taxpayer had an undivided half share in the whole of the Watershed timber subject to a duty to make stumpage payments to Scott at rates fixed in Exhibit 2 in any year in which taxpayer's half share of the Watershed timber exceeded the cut from its former separate timber. In the years in issue, 1956-57, taxpayer's half of the harvest from the Watershed timber did, in fact, exceed the cut from its former separate timber. (Supp. Pret. Ord., Para. 2(m), R. 11-12).

Tax Reporting Positions Taken by Taxpayer and Scott

Taxpayer and Scott each claimed capital gain benefits under Section 631(a) of the Internal Revenue Code of 1954 (and its predecessor Section 117(k)(1) of the 1939 Code) on timber harvested from the

Watershed. (Supp. Pret. Ord., Para. 2(j), R. 10). This provision authorized them to report their gains from the Watershed timber as capital gains to the extent that the fair market value of the timber in the year of cutting exceeded their adjusted basis for the timber.

Taxpayer's claim of Section 631(a) benefits is limited to those benefits arising from gains realized *by taxpayer* from its half of the Watershed timber—including the gains taxpayer realized from the timber acquired from Scott at the 1946 stumpage prices fixed by Exhibit 2. (Supp. Pret. Ord., Para. 2(l), R. 11).

The obstacle to taxpayer's claim is that Scott claims the same benefits. Scott claims Section 631(a) benefits arising out of *all* gains on timber cut from Scott's former timber, including the gains *realized by taxpayer* from such timber. (Supp. Pret. Ord., Paras. 2(j) and (n), R. 10, 12-13).

Taxpayer's difficulty is aggravated by the fact that its initial claims were consistent with Scott's; that is, taxpayer initially based its claims to Section 631(a) benefits on the gains realized from its former separate timber. Thus, although taxpayer's half of the Watershed timber included some Scott timber during the Section 631(a) benefits on gains which it realized from years in issue, taxpayer initially omitted claiming

the Scott timber over and above the stumpage it paid Scott. (Supp. Pret. Order., Paras. 2(j) and (m), R. 10, 11-12).

In 1956, however, the Washington State Tax Commission held a hearing relating to the Business and Occupation Tax returns of Scott. (Supp. Pret. Ord., Para. 2(k), R. 10-11). Taxpayer participated with Scott in the hearing and, for this purpose, for the first time received an analysis of Exhibits 2 and 3 by legal counsel. (Supp. Pret. Ord., Para. 2(k), R. 10-11). As a result of the anaylsis, taxpayer and Scott urged, before the Tax Commission, the same characterization of the contracts as taxpayer asserts here. (Supp. Pret. Ord., Para. 2(k), R. 11).

Taxpayer has since conformed its Federal tax position, for the years in issue and subsequent years, to the position which taxpayer and Scott took before the Washington State Tax Commission. (Supp. Pret. Ord., Para. 2(l), R. 11). Scott, however, has abandoned that position and declined to conform its Section 631(a) claims to taxpayer's claims (Supp. Pret. Ord., Paras. 2(k) and (n), R. 11, 12). With taxpayer claiming Section 631(a) benefits with respect to gains from its half of the Watershed timber, and Scott claiming with respect to more than half (i.e. with respect to all gains from its former separate timber, which in 1956-57 constituted more than half the cut from the Watershed timber, Supp. Pret. Ord., Para.

2(n)), the overlap of claims to Section 631(a) benefits is apparent.[1]

SPECIFICATION OF ERRORS

1. The Trial Court erred in denying taxpayer capital gain rates under Section 631(a) of the Internal Revenue Code of 1954 on gains realized by taxpayer from timber it cut in the Seattle Watershed.

2. The Trial Court erred in holding, for reasons not explained in its Opinions, Findings, or Conclusions, that the stipulated proof was in even balance.

3. The Trial Court erred in failing to give sufficient weight to the undisputed facts that (i) taxpayer exclusively held the proprietary right in the timber essential to Section 631(a) benefits, (ii) taxpayer exclusively realized the gains on which the Section 631(a) benefits in issue are based, and (iii) only taxpayer reported such gains in taxable income.

4. The Trial Court erred in failing to give suffi-

[1]Because the statute of limitations has barred the government from reopening Scott's return for 1954 and 1955, taxpayer voluntarily dismissed its action for the years 1954-55 with respect to this issue. (Supp. Pret. Ord., Para. 2(n), R. 12-13). As a result, the government acknowledges that there has been no duplication of capital gain benefits received by the parties with respect to timber cut in the Seattle Watershed during the closed years, 1946 through 1955. In fact, taxpayer has paid $50,413 more for federal taxes during such years than it would have paid if it had asserted its present position from the beginning. Id.

While taxpayer's voluntary dismissal with respect to this issue for the years 1954-55 prevented (at taxpayer's expense) any prejudice to the government arising out of the conflict between taxpayer's and Scott's Section 631(a) claims for the years closed by the statute of limitations, the conflict remains, and must be resolved for the years 1956 and after. Taxpayer has assumed the burden of going forward, and the government is holding open the returns of both taxpayer and Scott pending a decision.

cient weight to the inequitable distortion of tax liability which results from a denial of taxpayer's claim.

5. Although the Trial Court did not give a rationale for its decision, it is probable that its holding was predicated in part upon erroneous failure to treat taxpayer as having cut taxpayer's half of the Watershed timber.

SUMMARY OF ARGUMENT

1. Section 631(a) permits capital gain treatment of gains realized on the cutting of timber by a taxpayer who owns or has a contract right to cut such timber. Its purpose is to give the timber holder who cuts timber the same capital gain opportunities enjoyed by holders who sell timber.

2. Taxpayer is exclusively vested with the proprietary interest in the timber which is essential to a Section 631(a) claim. By reason of its exclusive proprietary interest in the timber, taxpayer exclusively earned the gains which gave rise to the Section 631(a) capital gain benefits in issue.

3. Taxpayer, acting through Mountain Tree Farm Company, cut the timber from which the Section 631(a) benefits in issue were derived.

4. There is no rational alternative to approval of taxpayer's claim of Section 631(a) benefits on its half of the Watershed timber.

ARGUMENT

I. The Purpose of Section 631(a) Is to Permit Capital Gain Treatment of Gains Realized on the Cutting of Timber by a Taxpayer Who Owns or Has a Contract Right to Cut Such Timber.

Senate Finance Committee Report No. 627, Seventy-Eighth Congress, First Session, contains a clear and succinct statement of the purposes and operation of Section 631(a): (1944 Cum. Bull. 973, at 993)

> "Your committee is of the opinion that various timber owners are seriously handicapped under the Federal income and excess profits tax laws. The law discriminates against taxpayers who dispose of timber by cutting it as compared with those who sell timber outright. The income realized from the cutting of timber is now taxed as ordinary income at full income and excess profits tax rates and not at capital gain rates. In short, if the taxpayer cuts his own timber he loses the benefit of the capital gain rate which applies when he sells the same timber outright to another. . . .
>
> "In order to remedy this situation, it is proposed to amend the existing law as follows:
>
> "If the taxpayer so elects upon his return, the cutting of timber during the year by the taxpayer who owns or has a contract right to cut such timber is treated as a sale or exchange of the timber cut during the year and such cut timber is considered property used in a trade or business of the taxpayer for the purpose of section 117(j) of the Internal Revenue Code provided the taxpayer has owned such timber or held such contract right for a period of more than six months prior to the beginning of such year. Where such an election is made, gain or loss to the taxpayer is recognized in an amount equal to

> the difference between the adjusted basis for depletion of such timber in the hands of the taxpayer and the fair market value of such timber. The fair market value is determined as of the first day of the taxable year in which the timber is cut."

In short, Section 631(a) is intended to give the timber holder who cuts timber the same capital gain opportunities enjoyed by holders who sell timber outright. In particular, for the purposes of this case, it should be noted that: (i) Section 631(a) allows capital gain treatment on the cutting of timber for use in business by a taxpayer who owns or has a contract right to cut it; and (ii) the measure of the gains is the fair market value of the timber on the first day of the taxable year in which cut, less taxpayer's adjusted basis.

II. Taxpayer Is Exclusively Vested with the Proprietary Interest in the Timber Essential to a Section 631(a) Claim.

The Commissioner of Internal Revenue and this Court have declared that a requisite to Section 631(a) benefits is a proprietary interest in the timber producing the gains, i.e *an unrestricted right to sell the logs for the taxpayer's own account or to use them in the taxpayer's trade or business.* In Treasury Regulations § 1.631-1(b)(1) (1957) the Commissioner states:

> " . . . In order to have a 'contract right to cut timber' within the meaning of section 631(a) and this section, a taxpayer must have a right to *sell* the timber cut under the contract *on his own account* or to *use* such timber in his trade or business." (Emphasis supplied).

In Revenue Ruling 58-295, 1958-1 Cum. Bull. 249, at 250, the Commissioner further stated:

> "To be entitled to the benefits of Section 631(a) of the Internal Revenue Code of 1954 as the holder of a 'contract right to cut,' a taxpayer must have acquired under such contract a *proprietary interest* in the timber which he cuts. Compare *Helga Carlen v. Commissioner,* 220 Fed. (2d) 338 . . . . Where a taxpayer is granted a contractual right to cut and remove all or a described part of the merchantable timber on a particular tract of land, he has a proprietary interest in the timber cut by him *if at the time of the cutting he has an unrestricted right to sell the logs or use them in his trade or business.* If the circumstances are such that the grantor in fact takes for his own use or for sale on his own account substantially all of the logs cut, whether or not in the exercise of a right in the form of an option to purchase, the taxpayer-grantee will not be deemed to have an unrestricted right to sell logs or use them in his trade or business." (Emphasis supplied).

Prior to the ruling, this Court had already confirmed that an unrestricted right to sell or use the logs was requisite for Section 631(a) benefits. *Carlen v. Commissioner,* 220 F.2d 338 (9th Cir. 1955). There, the taxpayers' partnership acquired a right to cut timber, but agreed to sell all the logs to the owner of the timber. The Commissioner argued that the 1939 Code predecessor to Section 631(a) could not apply where the partnership did not have an unrestricted right to sell the timber or use it in its own business. This Court agreed. This Court again confirmed the need for an unrestricted right to sell or use the logs in *Ellison v. Frank,* 245 F.2d 837 (9th Cir. 1957). See also *Johnson,*

v. United States, 257 F.2d 530 (9th Cir. 1958).

In response to Seattle's requirement of a single logging operation, taxpayer and Scott united their Watershed timber in a joint venture arrangement under the 1946 contract admitted into evidence as Exhibit 2:

(i) *Equal contributions.* The parties agreed that their contributions to the venture would be equal. The possibility of inequality in their respective contributions of timber is dealt with by providing that the party contributing the lesser amount will purchase half the difference from the party contributing the greater amount at the 1946 stumpage values of $1.00-$7.00 per thousand fixed in the contract. (Exh. 2, Paras. I(a), at 2-3, and II(b), at 4-5).

(ii) *Equal sharing of risks.* The parties agreed to equal sharing of risks by assuming equal responsibility for costs, including costs of roads and Mountain Tree Farm Company's compensation. (Exh. 2, Paras. III, at 7-8, and VI, at 8; Exh. 3, Paras. II, at 5-6, and V, at 12-15). As a further refinement they adjusted the property tax burden, recognizing that taxpayer's timber was scheduled to be cut first so that, in the absence of an adjustment,

Scott would have been obliged to carry the tax burden for a greater number of years. (Exh. 2, Para. I(b), at 3-4).

(iii) *Equal sharing of control.* The parties are assured of equal control over the cutting operation through their joint ownership of Mountain. (Pret. Ord., Para. 2(i), R. 7). Further, the contract admitted into evidence as Exhibit 3 gives them a joint supervisory right over Mountain. (Paras. I(a), at 2-3; III(a), at 7, and (d), at 9; IV (b), at 10, and (c), at 10-11; VI, at 15-16).

(iv) *Equal sharing of gains.* The parties have shared equally all gains which have accrued after the signing of Exhibit 2 in 1946. One source of such gains is appreciation of the standing timber (which is the gain described by Section 631(a)). It is apparent that *this gain inheres in the timber itself and can be realized only by the party which has the proprietary right to use the timber or sell it for its own account.* It is undisputed in this action that the Watershed timber was shared equally without regard to the land from which it came, and without restraint on its use or disposal. It follows, therefore, that the gains accruing by appreciation of the timber, following its contribution to the venture at the

1946 stumpage values of $1.00-$7.00 per thousand, were shared equally by taxpayer and Scott.[2]

Recall that the Section 631(a) formula for capital gain benefits is "fair market value" less basis. Thus, as timber appreciates, capital gain benefits increase. In other words, the gains shared equally by taxpayer and Scott gave rise to Section 631(a) benefits.[3] Taxpayer contends that, just as risks, control, and gains have been shared equally since the venture started in 1946, so should the Section 631(a) benefits arising from the venture's gains be shared equally.

Taxpayer's difficulty is that Scott claims more than half the Section 631(a) benefits. We know of no plausible rationale for Scott's claim. The Trial Court didn't suggest one, and we don't believe the government can either. It is true that, for the years in issue, the timber contributed to the venture by Scott constituted more than half the Watershed harvest. (Supp.

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[2]Any gains which may have been realized by the contribution of the timber to the venture at prices of $1.00-$7.00 per thousand were, of course, for the account of the party making the contribution. In this regard, it should be understood that the provision of Paragraph IV of Exhibit 2 that each party will assume the risk of casualty losses to its own timber is not an exception to equal sharing of losses, because it can affect only appreciation in the timber accruing *prior* to formation of the venture in 1946. Loss of appreciation accruing in the timber during the life of the venture is necessarily shared equally by the parties by reason of their equal sharing of the harvests. In other words, if all Scott timber should be destroyed, Scott loses the $1.00-$7.00 per thousand at which the timber is to be contributed to the venture, but taxpayer and Scott are equal losers of the gains they would have shared from the timber's appreciation over the 1946 stumpage prices.

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[3]The way in which Section 631(a) benefits operate to mitigate tax liability is discussed, *infra*, IV.A (iii), pp. 29-35; see Appendix C, p. 43 for a summary of an example tax computation involving Section 631(a).

Pret. Ord., Para. 2(m), R. 12). Prior to signing Exhibit 2 in 1946, Scott, of course, held the proprietary interest in all its timber. Any gains accruing from appreciation in the timber up to that time could be realized only by Scott through its exercise of its proprietary right to sell or use the timber. But Exhibit 2 changed that situation. It committed half the Watershed timber to taxpayer regardless of the land from which it came. (Pret. Ord., Para. 2(h), R. 6). It was, in fact, an exercise of Scott's right to sell or use the timber. Exhibit 2 thereby terminated Scott's proprietary right to sell or use *any portion of Scott timber which happened to be included in taxpayer's half of the Watershed timber.* Thereafter, Scott had only the right to demand that taxpayer even up the contributions to the venture by paying Scott at the agreed \$1.00-\$7.00 rate for Scott's excess timber contribution. By the same token, taxpayer was committed to an equal contribution to the venture either in its own timber or in Scott timber acquired for cash at the \$1.00-\$7.00 stumpage rates. Taxpayer thereby assumed half the market risks and half the market opportunities. Necessarily, any gains to be realized, by appreciation after 1946 of taxpayer's half of the Watershed timber, were for taxpayer's account realizable solely through the exercise of taxpayer's proprietary right to sell or use the logs. To the extent that timber from Scott lands was included in taxpayer's half of the harvest, only taxpayer could realize the post-1946 gains from it. *It is solely the Section 631(a) benefits arising from these gains (i.e.*

gains from former Scott timber included in taxpayer's half of the harvest) which are at issue here. In other words, the Section 631(a) benefits claimed by taxpayer are solely those arising from gains *actually earned* by taxpayer from its half of the Watershed timber. Such gains, to the extent they were derived from timber acquired from Scott, were measured, for Section 631(a) benefit purposes, by ascertaining the timber's fair market value and then subtracting the \$1.00-\$7.00 stumpage payments, which taxpayer made to Scott.

We submit that it makes no sense for Scott to claim Section 631(a) benefits on gains which taxpayer earned. Further, it is contrary to the holdings of the Commissioner and this Court to claim Section 631(a) benefits unless one has the proprietary right to sell or use the timber producing the benefits. (Rev. Rul. 58-295 and *Carlen v. Commissioner, supra*). The benefits in issue here accrued *after* Scott had signed Exhibit 2, limiting its proprietary right to just half the Watershed timber and vesting the other half in taxpayer.

Scott predicates its case on its greater contribution of timber during the years in issue. Scott forgets that contributions to the venture were required to be equal. Under Exhibit 2, taxpayer had the right, and the duty, to make up any deficit in timber contribution by a cash payment to Scott at the 1946 \$1.00-\$7.00 stumpage prices. In other words, taxpayer was required to acquire enough timber from Scott to make

its contribution equal to Scott's. Accordingly, there is no justification for Scott claiming Section 631(a) benefits arising from gains which it did not earn and derived from timber which it could not sell or use.

III. Taxpayer, Acting through Mountain Tree Farm Company, Cut Its Half Share of the Watershed Timber.

The Trial Court has not explained how he reasoned to his decision. Even the vague reasons mentioned in his February 2, 1966, memorandum decision (R. 14) were substantially withdrawn in his April 20, 1966, Order Denying Motion for Reconsideration (R. 17). We are told only that the stipulated proof is "in even balance" so that "the ruling of the Commissioner under review should not be reversed" (R. 17).[4] Consequently we must speculate about the Court's rationale.

Based upon the colloquy at trial and the Court's memoranda, we believe that the Court had no doubts about the validity of taxpayer's case to the extent discussed above. Rather, we have inferred that the Court was in some way concerned about the right to enter and cut in a literal sense, i.e. the right to wield the ax.

Of course, no corporation can cut timber or wield an ax in a strictly literal sense. Corporations are creatures of the law, dependent for their existence on scraps of paper properly signed and filed. Axes (or,

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[4]The Trial Court's reliance on a "ruling" is misplaced, since the government has simply held open the returns of both taxpayer and Scott pending resolution of the dispute between them. See n. 1, supra, p. 12.

more modernly, chain saws) must always be wielded by real people. Yet the government will acknowledge that corporations, as well as individuals, may enter and "cut" timber within the meaning of Section 631(a). Even the Trial Court implicitly recognized the capacity of a corporation to "cut" timber. It is apparent from the Trial Court's Memorandum Order Dismissing Action (R. 14) and Order Denying Motion for Reconsideration (R. 17) that it regarded a corporation, i.e. Mountain Tree Farm Company, as the party which "cut" the Watershed timber.

Why didn't the Trial Court consider the timber to have been "cut" by the individuals who actually wielded the axes and saws? What was the basis for the Trial Court's implicit assumption that Mountain Tree Farm Company, rather than real woodsmen, cut the Watershed timber? The answer is that actions of real people may, under certain circumstances, be imputed to other persons, including corporations. The Commissioner of Internal Revenue has established the rules for imputing the actions of an acting party to a taxpayer for tax purposes. In this appeal, we accept his rules without equivocation. The Commissioner will impute actions to a taxpayer whenever the following circumstances occur:

(i) *Benefit.* The taxpayer benefits from the actor's actions.

(ii) *Risk.* The costs, and therefore the risks, of the actor's actions are for the account of the taxpayer.

(iii) *Control.* The actor's actions are controlled by the taxpayer as to general purpose or result.

See the Commissioner's contentions set forth in this Court's decision in *Achong v. Commissioner,* 246 F.2d 445 (9th Cir. 1957), and the excerpts from the Commissioner's brief in the recent case of *H-H Ranch, Inc. v. Commissioner,* 357 F.2d 885 (7th Cir. 1966), contained in Appendix B to this brief. The Commissioner's rules are common sense rules. They would make sense to a businessman or anyone else accustomed to dealing in the practical affairs of the world. They are rules which are necessarily applied when any "act" of a corporation is involved. In the light of these rules, we can see why the Trial Court did not regard the woodsmen who actually cut the Watershed timber as having "cut" it for Section 631(a) purposes. It is apparent that the Court assumed the woodsmen to have been mere wage earners who received no benefit from the cutting (aside from wages), assumed no risk, and exercised no control. We agree (and believe the government will also agree) that, under the Commissioner's rules, the Trial Court's implicit reasoning was sound as far as it went.

Application of precisely the same rules will demonstrate that *taxpayer and Scott, not Mountain Tree Farm Company, "cut" the Watershed timber* within the meaning of Section 631(a):

(i) *Benefit.* The benefit from cutting timber is derived from the fact that timber which is felled,

bucked and delivered to the pond or dump is more valuable than timber still on the stump. If the value added to the timber by logging exceeds the cost of logging, a profit can be made on the operation. The Trial Court recognized that no woodsman working for wages could realize that benefit. What the Trial Court failed to appreciate was that neither could Mountain Tree Farm Company realize that benefit under the provisions of Exhibits 2 and 3. Such benefit inheres in the timber. It is necessarily realized by the party receiving and disposing of the timber. Mountain had a duty to deliver the Watershed timber to taxpayer and Scott. (Exh. 3, Para. IV(d), at 11-12). Mountain's position was the same as the individual woodsmen who wielded the axes. Mountain received no benefit from the cutting except its agreed compensation of 50¢ per 1,000 feet. (Exh. 3, Para. V, at 12-15). In short, Mountain was a mere wage earner. With respect to taxpayer's half of the Watershed timber, taxpayer benefitted exclusively from the ax wielding of the woodsmen.

(ii) *Risk.* The risk of cutting timber lies in the possibility that the cost of cutting, including roads, labor and equipment, may exceed the value added to the timber. The Trial Court rightly assumed that the woodsmen bore no part of this risk, but apparently failed to see that Mountain did not either. Pursuant to Exhibit 3, Mountain worked under a cost plus fixed compensation arrangement. Taxpayer and Scott were each obliged to pay half the costs of logging the Watershed timber, including

costs for roads and Mountain's compensation. (Exh. 2, Paras. III, at 7-8, and VI, at 8; Exh. 3, Paras. II, at 5-6, and V, at 12-15).

(iii) *Control.* "Control" has the same meaning with respect to timber cutting that it has in any other context. Neither the woodsmen nor Mountain had the right of control over the harvesting of the Watershed timber. Control over Mountain's cutting of the timber was shared equally by taxpayer and Scott. We have already seen that each owned half of Mountain's stock (Pret. Ord., Para. 2(i), R. 7) and that Exhibit 3 gave them a supervisory right over Mountain, which included control over the type of forest products cut (Para. I(a), at 2-3), the right to curtail or suspend production or to increase it (Para. III(a), at 7), the right to designate the areas for logging and the order in which such areas were to be logged (Para. III(a), at 7), the right to designate seed areas and to change such designations (Para. III(d), at 9), the right to specify delivery points (Para. IV(b), at 10), the right to direct the method of sorting and rafting logs (Para. IV(c), at 10), and ". . . the right to exercise general supervision . . . over the operations . . ." (Para. VI, at 15).

It seems clear that, under the Commissioner's rules for imputing actions to taxpayers, the cutting action by the woodsmen with respect to taxpayer's half of the Watershed timber cannot be imputed to Mountain. Mountain was a mere conduit through which the bene-

fit, risk, and control of cutting flowed directly to taxpayer and Scott.

Once it is understood that the cutting action by the woodsmen must be imputed to taxpayer and Scott for Section 631(a) purposes, the conclusion follows inescapably that taxpayer "cut" its half of the harvest. Obviously, the cutting of the *entire* harvest cannot be imputed to Scott—only the cutting of half. Scott enjoyed only half the benefit from the cutting of the Watershed timber (since it received only half the harvests), bore only half the risk (since it paid only half the costs) and exercised only half the control. The half of the cutting activity imputed to Scott should be that cutting which is attributable to the half of the timber which Scott received. In other words, only half of the cutting can be imputed to Scott, and that half is entirely absorbed by attribution to Scott's half of the harvest. Therefore, Scott did not cut taxpayer's half of the harvest, so that (with Mountain and its woodsmen eliminated from contention as mere wage earners) either taxpayer must be considered as having cut such timber, or we are left with the paradox that it was logged without having been "cut" by anyone.

The conclusion that taxpayer cut its half of the harvest is reinforced by the fact that taxpayer, by its receipt of such timber, was exclusively able to benefit from such cutting.

IV. There Are No Rational Alternatives to Taxpayer's Claim of Section 631(a) Benefits on Its Half of the Watershed Timber.

Before acquiescing in Seattle's request that they join in a single logging operation, taxpayer and Scott necessarily held, between them, all of the Section 631(a) rights with respect to their collective Watershed holdings. The government has acknowledged this by permitting them to claim Section 631(a) capital gain benefits on all such timber for the years 1946 through the years in issue. (Supp. Pret. Ord., Para. 2(j), R. 7). Consequently, taxpayer's claim to Section 631(a) benefits on its half of the Watershed timber can be supported by a demonstration that the only conceivable alternatives to its claim are manifestly unreasonable, i.e. that (i) Scott cannot reasonably claim such benefits, and (ii) the benefits should not be considered to have been lost by reason of the parties having acquiesced in Seattle's request for a single logging operation.

A. Scott Cannot Claim the Section 631(a) Benefits Arising Out of Gains Realized by Taxpayer from Its Half of the Watershed Timber.

Any one of three facts makes manifestly unreasonable a claim by Scott to Section 631(a) benefits on gains realized by taxpayer from taxpayer's half of the Watershed timber:

(i) The first fact has been discussed in section II of this brief (*supra*, pp. 15-22). There, we called attention to the undisputed fact that taxpayer possessed the essential proprietary interest, i.e. an un-

restricted right to sell for its own account, or use in its trade or business, its half share of the Watershed timber. In fact, taxpayer used its half share in its manufacturing business. (Pret. Ord., Para. 2(h), R. 7). It follows that Scott is thereby excluded from enjoyment of that essential proprietary right with respect to taxpayer's half of the Watershed timber. The decisions of this Court in *Carlen v. Commissioner, supra,* and *Ellison v. Frank, supra,* unequivocally preclude a claim by Scott to Section 631(a) benefits with respect to gains which accrued from appreciation of such timber *after* it was committed to taxpayer under Exhibit 2.

(ii) Second, Scott cannot be considered to have "cut" taxpayer's half of the Watershed timber for the reasons stated in section III of this brief (*supra,* pp. 22-27).

(iii) A third reason why Scott cannot reasonably claim Section 631(a) benefits on gains realized by taxpayer from taxpayer's half of the harvest is that such a claim leads to a tax absurdity unprecedented in the tax law. To appreciate the absurdity, the capital gain computation provisions of the Internal Revenue Code of 1954, as applied to this case, must be considered.[5] For this purpose, assume as a simple example that both taxpayer and Scott have $1,000 of ordinary income, with deductions of $900, resulting in $100 of taxable income. At the effective corporate rates for the years in issue (52%), each would ex-

[5]An example tax computation with full explanation is set out in the text, pp. 29-35; for a one-page summary of the computation see Appendix C, p. 43.

pect to pay a tax of $52 (ignoring the surtax exemption which does not appreciably affect the overall rates of large corporations):

	Taxpayer	Scott
Ordinary Gross Income.....	$1,000	$1,000
Less Deductions	– 900	– 900
Taxable Income	100	100
Effective Tax Rate	x 52%	x 52%
Tax	$ 52	$ 52

Now inject into the picture Section 631(a) gains. We have seen that such gains are measured by first ascertaining the fair market value of the timber on the first day of the year in which cut, and then subtracting basis. Assume an extreme case wherein all of taxpayer's former separate timber has been destroyed and harvests are *exclusively* from Scott timber. Assume a harvest of 5,000 board feet so that taxpayer's half would be 2,500 BF. Assume further a fair market value for the standing timber of $47 per thousand (a realistic value for the years in issue). Taxpayer's payment to Scott (and thus taxpayer's basis) would be, under Paragraph II(b) of Exhibit 2, $1.00 to $7.00 per thousand BF. Taxpayer would realize at least $100 of Section 631(a) gain on the cutting of the Scott former separate timber:

Fair market value of former Scott timber included in taxpayer's half of the Watershed harvest (2,500 BF at $47 per M)......	$117.50
Less stumpage paid Scott under Exhibit 2 ($7.00 per M)	17.50
Gain realized by taxpayer.................	$100.00

It is the Section 631(a) benefits attributable to *this gain from former Scott timber, realized by taxpayer,* that taxpayer and Scott have both claimed. Note here that, while the *measure* of such gains, for the purpose of Section 631(a) benefits, is by reference to value at cutting, in the real financial world income is not realized, in fact, simply by sawing down trees. In the financial world, the tree, or the products manufactured from it, must be sold before gain is realized. The importance of this financial fact is that, since only taxpayer actually received its half of the Watershed timber and used it, only taxpayer can earn any real dollars from it to report in gross receipts. Scott, not having received taxpayer's half of the harvest, cannot sell or use it and thus cannot earn the gains in issue here.

All that Scott can earn in a financial sense are the gains from its *own half* of the harvest. If (to keep our example simple) we assume that Scott's cost for the timber was the same price charged to taxpayer ($7.00 per M), then Scott's gain on its half of the harvest will also be $100.[6] Accordingly, taxpayer and Scott will *each* have their taxable income increased by $100 (assuming no additional deductions) as a result of their Watershed venture:

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[6]In n. 2, supra, we acknowledged that any gain Scott may have realized by contributing timber to the venture at $1.00-$7.00 per thousand is for Scott's account. Capital gain benefits from that gain are not in issue, so for simplicity's sake, the example assumes there is no such gain and concerns itself solely with gain realized after formation of the venture.

	Taxpayer	Scott
Ordinary Taxable Income........	$100	$100
Gains from Respective Halves of Scott Former Separate Timber...	100	100
Taxable Income	$200	$200

Note that, up to this point in the computation, capital gain income has been treated just like any other income. Section 61, defining "gross income," does not distinguish between capital gain and ordinary income. A dollar of capital gain increases gross income exactly as does a dollar of ordinary income. In the case of *corporations,* this is also true of taxable income. A dollar of capital gain increases *corporate* taxable income just as much as does a dollar of ordinary income (because Section 1201, which allows individuals a deduction of 50% on capital gains, does not apply to corporations). However, ultimately, when the corporation reaches the point of calculating the tax to be paid on its taxable income, it receives a benefit for capital gains. Section 1201 (entitled "Alternative Tax" because it applies only if it imposes a lower overall tax than the other tax imposing sections of the Code) is the only section providing a capital gain benefit for corporations.[7] In substance, it permits the corporation to extract, from

[7]Section 1201 provides, in pertinent part:

"Sec. 1201. Alternative Tax.

"(a) Corporations.—If for any taxable year the net long-term capital gain of any corporation exceeds the net short-term capital loss . . . there is hereby imposed a tax . . . of—

"(1) a partial tax computed on the taxable income reduced by the amount of such excess, at the rates and in the manner as if this subsection had not been enacted, and

"(2) an amount equal to 25% of such excess . . . ."

taxable income, all capital gains (including Section 631(a) gains) and pay a tax thereon at the rate of 25%. *Only the reduced balance of the taxable income is thereafter taxed at the regular corporate rate.* Applied to taxpayer in our hypothetical, Section 1201 will produce a tax of $77:

An amount equal to 25% of the capital gain ($100 x 25%)	$25
A partial tax on taxable income (reduced by the amount of capital gain) at ordinary 52% rates (i.e. $200 taxable income reduced by $100 capital gain equals $100 x 52%)	52
Tax	$77

The above computation illustrates the corporate capital gain benefit in action. It serves, at the end of the tax computation, to shield capital gain income from ordinary tax rates and permits taxation at a 25% rate instead.

If taxpayer does not prevail here, and cannot apply Section 1201 to its gains realized from the Watershed venture, it cannot simply eliminate such gains from its taxable income. The gains were realized from the use of such timber and must be reported. No court can authorize the exclusion of such gains. All this Court can decide is whether taxpayer can report such gains at capital gain rates or must report them at ordinary rates. In the example, if taxpayer were to be denied the Section 631(a) benefits attributable to the gains it realized from the Watershed venture, taxpayer's entire taxable income of $200 would be taxed at the 52% rate for a tax of $104:

An amount equal to 25% of the capital gain ($0 x 25%) . . . .$ 0

A partial tax on taxable income (reduced by the amount of capital gain) at ordinary 52% rates (i.e. $200 taxable income reduced by $0 capital gain equals $200 x 52%) 104

Tax $104

Contrast taxpayer's situation with that of Scott. Scott has received only *half* the harvest timber and has, accordingly, been able to earn only *half* of the gains derived from appreciation over 1946 values. Thus, only *half* the gains are included in its taxable income. If Scott is allowed to claim Section 631(a) benefits with respect to *all* gains realized from its former separate timber, *as if it had earned all such gains,* the results, in our example, will be as follows:

An amount equal to 25% of the capital gain ($200 x 25%) $50

A partial tax on income (reduced by the amount of capital gain) at ordinary 52% rates (i.e. $200 of taxable income reduced by *both* Scott's $100 of capital gain *and* *taxpayer's* $100 of capital gain, equals $0 x 52%) 0

Tax $50

Thus, we see that, although only $100 of capital gain was earned by Scott and included as part of its taxable income, Scott will claim $200 of capital gain benefits *solely for the purposes of the Section 1201 computation.* Scott will have claimed Section 631(a) benefits on gains actually earned and included in taxable income by taxpayer. In other words, Scott will have

effectively split off the tax benefits from the tax liability, shifting the benefits to itself and leaving the liability to be borne by taxpayer at ordinary rates. Thus, although the example assumed that taxpayer and Scott had the same amount of ordinary income and the same amount of capital gain, Scott's tax is \$50, while taxpayer's is \$104. The government will concede, we believe, that the splitting of Section 631(a) benefits from the tax liability giving rise to such benefits is unprecedented in the tax law. Yet such is the absurdity which must follow if Scott is allowed to claim the Section 631(a) benefits arising out of all gains realized by the joint venture from Scott former separate timber.

B. The Section 631(a) Benefits Arising out of Gains Realized by Taxpayer from Its Half of the Watershed Timber Were Not Lost.

For the sake of completeness only, we mention here the possibility that the Section 631(a) benefits, which both taxpayer and Scott claim, may have been lost by the uniting of the taxpayer-Scott interests. The government has never asserted such a possibility. On the contrary, the government has each year acquiesced in the claiming by taxpayer and Scott of Section 631(a) gains on *all timber* cut in the Seattle Watershed. (Supp. Pret. Ord., Para. 2(j), R. 7). Throughout negotiations concerning the proper apportionment of such benefits between Weyerhaeuser and Scott, the government has indicated a willingness to agree to any apportionment acceptable to taxpayer and Scott.

Accordingly, we asserted before the Trial Court without opposition from the government:

> "The government does not deny that someone has the right to treat plaintiff's gains as realized under Sec. 631(a). The government is perplexed, however, because another party claims the same right with respect to the same gains. That other party is Scott Paper Company. As between plaintiff and Scott, the government is economically neutral. It is reconciled to one party successfully making the claim, but it does not wish to have both plaintiff and Scott do so. To protect itself against such a possibility, the government is taking Scott's position in this action. If plaintiff prevails here, the government will take plaintiff's position against Scott before another court." (Plaintiff's Opening Brief, at 12-13).

> " . . . It is important to remember, however, that the government has at no time contended that the arrangement resulted in the loss of Sec. 631(a) benefits on the watershed timber. The government acknowledges that, notwithstanding the arrangement, Weyerhaeuser and Scott, between them, hold all the requisite Sec. 631(a) rights. The problem this court faces is deciding the correct way to apportion Sec. 631(a) benefits on watershed timber." (Plaintiff's Post-Trial Brief, at 4-5).

For the three reasons mentioned in subsection IV. A above, we cannot believe that the Trial Court found any merit in Scott's claim to the Section 631(a) benefits arising from taxpayer's gains on taxpayer's half of the Watershed timber. Since the only other alternative to a decision in favor of taxpayer is a conclusion that such benefits simply disappeared, we have been forced to inquire whether this was the Trial Court's

unspoken conclusion. We submit that such a conclusion is manifestly unreasonable. First, there is no support for it in statute, regulation or case law. Second, it is completely unsatisfactory logically to conclude that Section 631(a) benefits which taxpayer and Scott undeniably held as owners of all the Watershed timber should have disappeared simply because they united their timber and logged jointly. Finally, it would be an inequitable paradox if the uniting of taxpayer-Scott holdings in the public interest should result in a tax penalty.

The government is obliged to defend this action in order to protect itself vis-a-vis Scott. However, to avoid the confusion which evidently troubled the Trial Court, we respectfully request that the government, in its answering brief, clarify its objectives. Does it seek a windfall for itself on a theory that the uniting of the taxpayer-Scott timber somehow caused the loss of Section 631(a) benefits which taxpayer and Scott had separately held before? If so, what is the rationale for the loss of the benefits? If the government claims no windfall for itself, is not this Court called upon to decide only whether it is taxpayer or Scott which has the superior claim to Section 631(a) benefits attribu-

table to gains realized by taxpayer from its half of the Watershed timber?

Respectfully submitted,

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CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated this 15th day of June, 1967.

John T. Piper,
Attorney

APPENDIX A
Table of Exhibits

Plaintiff's Exhibit No.		Record Reference Showing Admission as Evidence (page)
1	Cedar River Watershed Logging Agreement	8
2	Contract (Weyerhaeuser-Scott)	8-9
3	Logging Contract (Weyerhaeuser-Scott-Mountain Tree Farm)	9
4	Map of Cedar River Watershed, Disclosing Scott-Weyerhaeuser Holdings	9
5	Settlement of Stumpage Cut by Mountain Tree Farm (Dec. 31, 1957)	13

APPENDIX B

Excerpts From Commissioner's Brief in *H-H Ranch, Inc. v. Commissioner,* 357 F. 2d 885 (7th Cir. 1966)

[pp. 16-21, 23-24]

That a taxpayer may be engaged in the business of holding property "primarily for sale to customers in the ordinary course of its trade or business" through the use of an agent and that the sales activities of the agent for the benefit of the principal will be imputed to the principal cannot be disputed. . . .

* * *

The position of the taxpayer is premised upon the separateness for tax purposes of the corporate entities represented by H-H Ranch, Inc., and Blackhawk Builders. (Br. 7.) That taxpayer and Blackhawk are separate corporate entities for tax purposes is not questioned. The Commissioner contends, however, and the Tax Court held, that an agency relationship existed between H-H Ranch, Inc., and Blackhawk Builders. (R. 64.) Therefore, the activities of Blackhawk in regard to the subdividing of the Elgin Farm property must be imputed to the taxpayer.

[BENEFIT]

. . . If Blackhawk was to remit to taxpayer the value of the lots less the cost of improvements made by Blackhawk, it would appear to be evident that Blackhawk could make no profit on the subsequent sale of the lots to third parties. Any resulting profits would benefit H-H Ranch, Inc., only . . .

[CONTROL]

. . . If Blackhawk was not the agent of H-H Ranch, it would not have been necessary to indicate the purpose for which the realty was to be conveyed, as a seller ordinarily would not do so in a sales agreement.

[RISK]

The agreement also provided that when Blackhawk sold a lot to a third party with a house constructed thereon or when Blackhawk obtained a construction permit for the construction of a home on a lot to be sold by it to a third party, then and only then would Blackhawk pay H-H Ranch the sum of $2,000 per lot. (R. 40-41.) Furthermore, any lots remaining unsold or unpaid for by Blackhawk at the end of five years were to be reconveyed to H-H Ranch, Inc., free and clear of all encumbrances. . . .

* * *

That the Tax Court was correct in its findings is apparent when it is realized that Blackhawk was under a contractual duty to pay for the lots only when they were sold to a third party either as a vacant lot or as a lot with a house constructed thereon. Thus, all the risks of a fall in the price level of realty in that area remained upon H-H Ranch, whereas Blackhawk was insulated from loss by the fact that no payment to H-H Ranch was required until the lot was sold. Thus, by refusing to sell the lots for less than $2,000, coupled with the right to reconvey any unsold lots, Blackhawk could not possibly incur any loss.

. . . The Tax Court further pointed out that H-H

Ranch itself paid at least some of the expenses incident to the platting and zoning of the subdivision, a fact which the court found to be inconsistent with the ownership of the land by Blackhawk and consistent with its character as the agent of taxpayer. (R. 63-64.) The Tax Court was therefore clearly correct in holding Blackhawk to be the agent of taxpayer. [Commissioner's Brief, pp. 16-21, 23-24].

APPENDIX C

Summary of Example Tax Computation from Text, pp. 29-35

1. Assumed Ordinary Income

	Taxpayer	Scott
Ordinary Gross Income	$1,000	$1,000
Less Deductions	– 900	– 900
Taxable Income	100	100
Effective Tax Rate	x 52%	x 52%
Tax	$ 52	$ 52

2. Taxpayer's Assumed Capital Gain

Fair market value of former Scott timber included in taxpayer's half of the Watershed harvest (2,500 BF at $47 per M)	$117.50
Less stumpage paid Scott under Exhibit 2 ($7.00 per M)	17.50
Gain realized by taxpayer	$100.00

3. Taxable Income

	Taxpayer	Scott
Ordinary Taxable Income	$100	$100
Gains from Respective Halves of Scott Former Separate Timber	100	100
Taxable Income	$200	$200

4. Correct Section 1201 Computation—Taxpayer

An amount equal to 25% of the capital gain ($100 x 25%)	$25
A partial tax on taxable income (reduced by the amount of capital gain) at ordinary 52% rates (i.e. $200 taxable income reduced by $100 capital gain equals $100 x 52%)	52
Tax	$77

5. Erroneous Section 1201 Computation—Taxpayer

An amount equal to 25% of the capital gain ($0 x 25%)	$ 0
A partial tax on taxable income (reduced by the amount of capital gain) at ordinary 52% rates (i.e. $200 taxable income reduced by $0 capital gain equals $200 x 52%)	104
Tax	$104

6. Erroneous Section 1201 Computation—Scott

An amount equal to 25% of the capital gain ($200 x 25%)	$50
A partial tax on income (reduced by the amount of capital gain) at ordinary 52% rates (i.e. $200 of taxable income reduced by **both** Scott's $100 of capital gain **and taxpayer's** $100 of capital gain equals $0 x 52%)	0
Tax	$50